1-1-1972

Discussant's response to toward standards for materiality(?)

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Discussant's Response to Toward Standards for Materiality(?)

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Mr. Holmes has prepared a very interesting and thought provoking paper on this elusive problem of materiality. As discussant it is my intention to reinforce and stress the importance of many of his points as they affect the accounting profession. A few of my own concepts on how to handle the problem will be given, either as a modification or an addition to his other comments and conclusions.

Various Meanings of Materiality

Mr. Holmes' references to legal opinions and interpretations given by regulatory bodies have brought out different shades of meaning associated with the word "material." Materiality, as it is used in the narrow sense, relates to the correct recording and reporting of accounting data. Mr. Holmes points out that for a statement to be considered "fair" it must be free of "significant distortion." This concept says that if a statement contains significant *accounting* errors, it should be corrected regardless of the surrounding circumstances and without the necessity of being concerned whether or not the error is large enough to influence the action of the "average prudent investor."

Materiality, in its broadest sense, is related to whether or not the item in question (e.g., the existence of an error) will likely influence the thoughts and actions of the reader when considered under the surrounding circumstances. There may or may not be significant distortion.

I believe that the profession should recognize the difference between the two meanings of materiality (significant distortion and materiality) and that, as Mr. Holmes suggests, the terms "significant distortion factor" and "materiality factor" could be used to identify them. His suggested rule of "lower of standard distortion factor or materiality factor" may become generally accepted by the profession.

Setting Standards

In response to the problem of whether the profession *can* set standards for judging significant distortion and/or materiality, Mr. Holmes implies that it might be possible to establish standards for the former. But he says, "It may be said that *any* decision by an accountant as to materiality in a particular case is always correct *short of a court of law*." It is hard to believe that a materiality decision is correct just because it has not been challenged and settled in court. If so, how do we explain the situation where one qualified accountant, after giving consideration to all surrounding circumstances says an item is material while an equally qualified accountant in the same situation says it is not material. Both decisions cannot be correct. Probably what he means is that until a court has decided a case involving materiality no one knows for sure what the *legal* answer is. That situation—difference of opinions (based primarily upon *judgment*) of company accountants, independent auditors, SEC, courts, security analysts, and others—stresses the need for more *objective* guidelines for making materiality decisions as well as decisions related to significant errors.

If this need *is* urgent, should the accounting profession undertake to establish acceptable standards to guide the accountant in his distortion/materiality decisions? Can such standards be set? I wish to give an affirmative response to each question and would like to express my belief as to the *type* and *form* of such standards and to recommend a *general* approach on how to set them.

The errors referred to when attempting to determine if their existence significantly distorts financial statements include errors in recording amounts (or failure to record), errors in statement presentation (e.g., wrong classification of an item or failure to set it out separately), and failure to disclose pertinent information (such as the existence of a contingent liability). It is to be recognized that some errors, because of their nature are not subject to being judged by a significant distortion factor. The answer to the question of how large an error may be before it results in significant distortion may be based on a *relative* amount, expressed percentagewise with upper and lower limits. Suppose that, for a particular type of error, the most relevant base for judging significant distortion is average net income. The *primary* standard distortion factor could be expressed, for example, as 7%—10% of average net income. An error above 10% should be considered as significant, and one below 7% as not significant, unless the accountant can justify departure from this guideline. The gray area (7% to 10%) recognizes that no attempt should be made to set an *exact* dividing line between significant and insignificant errors. A precedent for setting this type of guideline is found in the Committee on Accounting Procedure pronouncement that in the case of stock dividends, retained earnings should be charged for par (or other legal capital base) for *large* dividends and charged with market price of the stock for *small* dividends. The Committee gave a dividend rate range of 20% to 25% as a basis for distinguishing between large and small stock dividends.

For a given instance of an error it is usually necessary to recognize that the significance of an item may have to be judged on two or more bases. A guideline for each base should be established (e.g., 12%—15% of stockholders' equity, 9%—12% of current assets, etc.). An error (or accumulation of errors) would be considered insignificant only if it was found to be insignificant by *each* of the tests applied.

I suggest that some board, such as the newly approved Financial Accounting Standards Board, should be responsible for determining which situations involving errors should have significant distortion factors set for them and it should establish upper and lower limits of the factor in each case. The board need not undertake to study the *entire* problem of significant distortion as one project with the hopes of coming up with a pronouncement covering the entire field. Instead, a study resulting in a pronouncement could be made of each type of significant distortion, each taken one at a time.

The board, using questionnaires and personal interviews, could identify the most frequently found instances on which accountants have found it necessary to make a significant distortion decision, could determine bases and percentages that have been used in actual practice, and could, after presenting an exposure draft based on the study, come up with guidelines for making a decision related to the type of error in question. Instances of a professional organization or a governmental agency providing numerical guidelines for decision making are not unique. Many examples of this practice are found in APB Opinions and SEC Regulations.

Materiality Standards

But what about errors that are insignificant, but which might be considered as material such that under the existing circumstances they would influence the action or opinion of the reasonably prudent investor, etc.? If the importance of an error is to be determined by Mr. Holmes' rule of "lower of significant distortion factor or materiality factor," there should be some way of determining the latter measure. Mr. Holmes correctly says "we have a way to go before we come close to standardizing that." It is certainly recognized that considerable judgment by the accountant is necessary to decide whether an error or other item would likely influence or mislead an informed reader.

Factors to be considered in making a materiality decision may be of a quantitative nature or of a non-quantitative nature or both. The accountant's judgment may be the *sole* basis for determining materiality if factors to be considered are non-quantitative. However, even in that situation, a standard may provide that the mere existence of an item or circumstance should require its disclosure or special reporting. For most materiality decisions involving *accounting* (quantitative) data, it should be possible to set standards in somewhat the same form as those suggested to provide guidelines for judging significant distortion. Some of these standards could be different in two respects. They could require use of a different base or have a different border zone.

For example, in his recent *Journal of Accountancy* article, Mr. Holmes referred to a recommendation by a well-known analyst that materiality of an error in earnings "be based on the percent of change from the prior year rather than the percent of net income."

In many instances, it may be possible to use the *same* base for a materiality factor—but to set different percentages for the border zone than were set for the significant distortion factor. For example, if the investor likely would be *sensitive* to a change in *trend* of earnings, the standard distortion guideline could be reduced by a certain number of percentage points (hereinafter called points) to provide new limits for judging materiality. Additional circumstances may be found in a particular company such that an error would be considered material for decision and analytical purposes even though it would not result in significantly distorted financial statements. For each type of circumstance a certain number of points could be set as a basis for lowering the guidelines for judging significant distortion to give guidelines to be used to judge materiality. This procedure is somewhat in line with the thinking expressed in Mr. Holmes' paper when he says, "Suppose we establish a 10 per cent factor for the income statement, and in a particular case the company is on the verge of breaking through a 'times interest' coverage factor affecting its bondholders where a 5 per cent change in income would spell the difference between interest covered and interest not covered. In this case the 10 per cent standard distortion factor might, in some situations, give way to the 5 per cent materiality factor." As Mr. Holmes suggests, circumstances which would cause the materiality factor to be higher should be ignored. Of those circumstances which would cause the materiality factor to be lower, the one which causes the standard distortion factor to be lowered by the greatest number of points should be used to obtain guidelines for judging materiality. As an alternate to using points for adjusting a significant distortion factor to obtain a materiality factor, link relatives may be used. For example, the guideline for judging significant distortion may be 8% to 11% of income in some cases. The existence of an unusual circumstance may require a "70% adjustment factor" which would result in the guideline for judging materiality becoming 5.6% to 7.7% (8% × 70% to 11% × 70%). If appropriate, more than one adjustment factor could be used in this link relative.

A study of all major distortion/materiality problems and the issuing of recommended guidelines for each will take several years. In the meantime, any issued guideline can be revised as it may become appropriate.

Mr. Holmes implies that it is possible to establish standards to measure significant distortion when he says, "My rule of 'lower of standard distortion factor or materiality factor' simplifies the problem at least 50 per cent." That belief certainly seems to be a reasonable one. Although I agree with him that the problem of determining materiality is a much more difficult one, it does seem that guidelines could be provided which would simplify the problem another 20 to 25 per cent.

Benefits

The establishment of guidelines with border zones would provide a tentative answer to a distortion/materiality decision. These benefits should result:

1. The guidelines should be the basis for settling a disagreement on the subject between the company and the independent auditor. The burden of proof is on the one departing from the guideline. The auditor would be much more inclined to "stick to his guns" if his decision agrees with the guidelines.
2. As Mr. Holmes says of court cases, "A judge would find a 'standard of significant distortion' set by the accounting profession a useful starting point in arriving at his decision in a matter involving materiality."
3. An Ethics Committee would have a better basis for making a decision.
4. The use of established guidelines should help close the credulity gap which exists in the minds of many readers who see two qualified accountants making opposite decisions. Statements should be more useful with controversial items handled on a uniform basis.

Mr. Holmes raises the question, "If we adopt standards of significance, how do we police our standards?" That question could be asked about the enforcement of any pronouncement or generally accepted accounting principle. Fortunately, most accountants are ethical and would try to make a correct decision on a difficult problem if they have some guideline for doing so.

Summary

I wish to commend Mr. Holmes on his very interesting and challenging paper. I agree with most of what he has said. I have tried to show how it would be possible to carry out some of his suggestions, especially those related to the establishment of significant distortion standards. I admit that I feel more optimistic than he and other accountants, as to the practicality of putting the process of making materiality decisions on a more objective basis.

I hope that, as a result of hearing Mr. Holmes' paper and his comments and participating in the discussion which follows, you will want to encourage the development of guidelines to help in the exercise of judgment in making materiality decisions.

Is there merit in trying to set standards? I think so. Will it be an impossible task? Difficult, but not impossible. Will the accounting profession rise to the challenge? I have confidence that it will.